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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 194

THE MONTANA POWER COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (Pet. 1a–13a) is reported in 121 F. Supp. 577. The opinion of the Court of Appeals (Pet. 15a–40a) is reported in 232 F. 2d 541.

JURISDICTION

The judgment of the Court of Appeals was entered on March 28, 1956. (Pet. 41a.) The petition for a writ of certiorari was filed on June 25, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

The taxpayer, a controlled and largely owned subsidiary of a parent corporation, exchanged its deben-

tures for the property, the fair market value of which is not shown, of a wholly-owned subsidiary of its parent in a nontaxable reorganization. The question is whether the District Court and the Court of Appeals were correct in holding that, in the absence of a showing that the principal amount of the bonds exceeded the fair market value of the property received in exchange, the taxpayer did not issue its bonds at a discount.

REGULATIONS INVOLVED

Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939:

> SEC. 19.22 (a)–18. *Sale and purchase by corporation of its bonds.*—* * *
>
> * * * * *
>
> (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *
>
> * * * * *

STATEMENT

The facts, as found by the District Court (Pet. 2a-4a), are as follows:

In 1931 the American Power & Light Company, a public utilities holding company, hereinafter referred to as American, acquired certain natural gas properties in Montana. In 1932 American transferred these properties to Montana Power Gas Company, an operating company, hereinafter referred to as Gas Company, in exchange for all of the stock of the latter. (Pet. 2a.)

In 1936 the Gas Company, while still wholly owned by American, transferred its assets and liabilities to the Montana Power Company, the taxpayer herein,

in exchange for which the taxpayer issued its thirty-year 5% debentures in the principal amount of $10,589,900 to the Gas Company. The taxpayer, like the Gas Company, was a controlled subsidiary of American, which at that time owned 99.75% of the common stock and 93.73% of all outstanding voting stock of the taxpayer. (R. 19a;[1] Pet. 2a.) As a consequence, under the revenue laws, the transaction constituted a tax-free reorganization, upon which no gain or loss was recognized, and the taxpayer was required to use as its basis for the assets acquired the adjusted basis which they had in the hands of the Gas Company, namely, the amount of $7,044,544.44. (R. 21a; Pet. 2a.)

The transfer, by tax-free reorganization, of the Gas Company's properties to the taxpayer in exchange for the taxpayer's bonds was pursuant to a plan submitted to and approved by the Federal Power Commission, which embodied in its approval of the agreement the following condition (Pet. 3a):

> It is understood that if the cost to American Power & Light Company (American) as provided in said order of the Federal Power Commission is not established, you (Gas Company) will return to us (Montana) such amount of debentures as shall be in excess of said cost so established.

The cost of the Gas Company's properties on the books of that company, as received from its parent

[1] Record references are to the Appendices to the taxpayer's brief and the Government's brief in the Court of Appeals.

company, American, and transferred to the taxpayer amounted to $11,183,595.53. (R. 24a–25a; Pet. 3a.)

In the stipulated statement of assets and liabilities transferred November 30, 1936, by the Gas Company to Montana under the plan of reorganization in exchange for the debentures, the net value of such assets is stated as $10,589,900. (Pet. 3a–4a; R. 1b–2b.)

In 1945, nine years after the issue of the debentures and twenty-one years before their maturity, they were retired by the taxpayer by paying in cash to certain banks the principal indebtedness of $10,589,900. (Pet. 4a.)

The taxpayer, after having duly filed a claim for refund and its claim having been disallowed, brought suit for refund in the District Court on the theory that the issuance of its debentures in 1936 to the Gas Company was made at a discount in the amount of the difference between the principal amount of the debentures and the basis, for tax purposes, of the property acquired in the exchange. This amount, $3,545,355.56, the taxpayer claimed it was entitled to amortize over the thirty-year life of the debentures, and it asserted that a deduction of one-thirtieth thereof, or $118,178.52, was proper in each taxable year. Based upon this claim, the taxpayer sought by its first, second and third causes of action, respectively, to recover the amount of $28,362.85 of its income taxes for 1940, $14,380.18 of its income taxes for 1941, and $70,899.92 of its excess profits taxes for 1941. (R. 3a–13a, 20a.)

The District Court held that, in the absence of a showing that the fair market value of the property

received by the taxpayer was less than the par value of the bonds issued in exchange therefor, the bonds were not issued at a discount. (Pet. 4a–14a.) (Pet. 12a.)

On appeal, the court below, sitting *en banc*, affirmed the District Court. All the members of the court except Chief Judge Biggs agreed that the taxpayer was not entitled to the bond discount deductions it seeks in view of its failure to establish the fair market value of the property involved. (Pet. 15a–22a.) An additional view, in the nature of a concurring opinion, was expressed by Judge Kalodner and concurred in by Judge Staley, that the Treasury Regulations relating to bond discount are inapplicable in situations where bonds are issued in payment for property. (Pet. 22a–30a.) A further additional view, also in the nature of a concurring opinion, was expressed by Judge Kalodner and concurred in by Judges Staley and Hastie, to the effect that the Treasury Regulations relating to bond discount cannot be invoked where there was no arm's length dealing between the seller and the purchaser. (Pet. 30a–32a.) Chief Judge Biggs wrote an opinion, dissenting in part and concurring in part. (Pet. 32a–40a.)

ARGUMENT

1. The decision of the court below, affirming the decision of the District Court, is clearly correct. In 1936 the taxpayer, in a statutory reorganization, exchanged its bonds of a par value of $10,589,900 for the property of the Gas Company (another controlled subsidiary of its parent corporation) having an ad-

justed basis of $7,044,544.44. (Pet. 2a, 17a.)[2] No gain was recognized on the transaction.[3] As a consequence, the Gas Company's basis for the bonds acquired was "the same as in the case of the property exchanged" (Sec. 113 (a) (6), Revenue Act of 1936, c. 690, 49 Stat. 1648), and the taxpayer's basis for the property acquired was "the same as it would be in the hands of the transferor" (Sec. 113 (a) (7)). The taxpayer's contention (Pet. 4) that it is entitled to deductions for amortization of bond discount in the amount of $3,545,355.56, the difference between the par value of the bonds which it issued and the adjusted basis in the hands of the Gas Company of the property received in exchange, which it was required to use solely because of the nontaxable nature of the exchange, was properly rejected by the courts below. Although there has been no specific provision in the Internal Revenue laws relating to the allowance of a

[2] The reorganization was pursuant to Section 112 (g) (1) (C) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, which provides:

"(g) *Definition of Reorganization.*—As used in this section and section 113—

"(1) The term "reorganization" means * * * (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred * * *"

[3] Section 112 (b) (4) of the Revenue Act of 1936, *supra*, provides:

"(b) *Exchanges Solely in Kind.*—

* * * * *

"(4) * * * *Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

deduction for bond discount, the Treasury Regulations have long and consistently provided,[4] as Section 19.22 (a)-18 (3) (a) of Treasury Regulations 103, *supra*, p. 2, applicable here provides, that if bonds are issued by a corporation at discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

The determination of bond discount in the case of an exchange of bonds solely for property, assuming *arguendo* that the discount regulation is applicable in such circumstances,[5] would necessarily be made by reference to the excess of the par value of the bonds over the fair market value of the property, as the court below concluded. (Pet. 22a.) In *Helvering* v. *Union Pacific Co.*, 293 U. S. 282, rehearing denied, 293 U. S. 630, the issue was whether the taxpayer was entitled to amortization deductions, under the Treasury regulation relating to bond discount deduction, with respect to commissions paid to bankers for marketing its bonds. This Court likened the commis-

[4] See Article 545 (3) (a) of Treasury Regulations 62, 65 and 69; Article 68 (3) (a) of Treasury Regulations 74 and 77; Article 22 (a)-18 (3) (a) of Treasury Regulations 86, 94 and 101; and Section 29.22 (a)-17 (3) (a) of Treasury Regulations 111. These Regulations were promulgated under the Revenue Act of 1921, 1924, 1926, 1928, 1932, 1934, 1936 and 1938 and the Internal Revenue Code of 1939, respectively.

[5] The court below found it unnecessary to decide whether Section 19.22 (a)-18 (3) (a) of Treasury Regulations 103, relating to the amortization of bond discount, applies in such circumstances, inasmuch as, in the absence of any evidence as to the fair market value of the property received by the taxpayer for its bonds, there was no occasion to apply the regulation here. (Pet. 22a.)

sions to bond discount and held that they were deductible in the same manner. It stated (p. 288):

> There is no occasion for deduction of commissions [here bond discount] from gross income * * * unless *the total amount realized* by the sale of the bonds is less than their par value. In that case the difference alone is the amount to be amortized and deducted from gross income in the annual returns of the taxpayer. * * * [Italics supplied.]

The "total amount realized" by the taxpayer here for the issuance of its debentures was clearly the fair market value of the property received in exchange therefor.[6]

The effect of the provision that the taxpayer use as its basis for the property acquired the adjusted basis which the property had in the hands of the transferor, the Gas Company, is to require that the taxpayer take the property subject to the potential realization of the gain to the transferor which escaped recognition because of its transfer pursuant to a nontaxable reorganization. *Schweitzer & Conrad, Inc.* v. *Commissioner*, 41 B. T. A. 533, 548, appeal dismissed July 8, 1941 (C. A. 7th). That gain ($3,545,355.56) consisted of the excess of the par value of the bonds ($10,589,900) over the adjusted basis of

[6] Section 111 (b) of the Revenue Act of 1936, applicable to the exchange of bonds for property here, provides that:

"(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

the property exchanged therefor ($7,044,544.44).[7] (Pet. 17a.) It is precisely that gain which the taxpayer seeks to label *bond discount*. The allowance of the amortization deductions sought manifestly would defeat the Congressional purpose in requiring that the taxpayer-transferee use as its basis for the property the adjusted basis of its transferor, the Gas Company.

No problem of double taxation (Pet. 16–17) is involved here. The record contains no evidence of a taxable disposition of either the bonds or the property. Even assuming there were such evidence, the application by the Gas Company and taxpayer of Section 113 (a) (6) and (7), respectively, of the Revenue Act of 1936, *supra*, in determining basis is the price of employing a nontaxable reorganization. The natural consequence of these provisions, undoubtedly contemplated by Congress, is the possibility, if each should dispose of what it received in the exchange at a gain, of a tax once against the transferor and once against the transferee. That would not constitute double taxation. Cf. *Newman, Saunders & Co.* v. *United States*, 36 F. 2d 1009, 1012 (C. Cls.), certiorari denied, 281 U. S. 760; *T. W. Phillips, Jr., Inc.* v. *Commissioner*, 63 F. 2d 101 (C. A. 3d).

2. No issue of general importance is raised by the decision below, as is indicated by the fact that, as the

[7] Section 111 (a) of the Revenue Act of 1936 provides:

"(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain * * *."

taxpayer points out (Pet. 6), the case is one of first impression. Moreover, the decision below is not in conflict with any decision of this Court or any other court of appeals. *Helvering* v. *Union Pacific Co.*, 293 U. S. 282, rehearing denied, 293 U. S. 630, relied upon by the taxpayer (Pet. 9), did not involve an exchange of bonds for property. In so far as anything said in that case is applicable here, it fully supports the decision below, as has been pointed out.

Neither does the decision below conflict with *Sacramento Medico Dental Building Co.* v. *Commissioner*, 47 B. T. A. 315. No nontaxable reorganization was involved there. In the portion of the opinion quoted and relied upon by the taxpayer (Pet. 6–7), the Board merely stated that if the circumstances suggested by the taxpayer there had been present (p. 329), "*then a strong argument might be made* that inequities would result from the disallowance of discount amortization". (Italics supplied.) However, the Board added (p. 329), "we do not have that question before us, and therefore, do not decide it."

3. This Court, contrary to the taxpayer's suggestion (Pet. 17–20), has not granted certiorari as a matter of course in cases involving questions arising under the Regulations relating to the taxability of bond premium and the deductibility of bond discount. Certiorari has frequently been denied in such cases,[8] and

[8] See, for example, *Lincoln Mortgage & T. Guar. Co.* v. *Commissioner*, 79 F. 2d 585 (C. A. 3d), certiorari denied, 296 U. S. 654; *New York Cent. R. Co.* v. *Commissioner*, 79 F. 2d 247 (C. A. 2d), certiorari denied, 296 U. S. 653; *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. 2d 990 (C. A. 7th), certiorari denied, 284 U. S. 618; *Commissioner* v. *Pittsburgh & W. V. Ry. Co.*, 172 F. 2d 1010 (C. A. 3d), certiorari denied, 337 U. S. 939.

in *Helvering* v. *Union Pacific Co.*, *supra*, *Gt. W. Power Co.* v. *Commissioner*, 297 U. S. 543, *Helvering* v. *Metro. Edison Co.*, 306 U. S. 522, and *General Gas & Electric Corp.* v. *Commissioner*, 306 U. S. 530, cited by the taxpayer (Pet. 18–19), certiorari was granted to resolve a conflict of decisions.

CONCLUSION

The decision of the court below is clearly correct and there is no conflict of decisions or other reason warranting review. The petition for a writ of certiorari should be denied.

Respectfully submitted.

OSCAR H. DAVIS,
Acting Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
LEE A. JACKSON,
WALTER AKERMAN, JR.,
Attorneys.

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